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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

January 10, 1997

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: In the Matter of Federal-State Joint Board on Universal Service,
CC Docket No. 96-45

Dear Mr. Caton:

Enclosed are an original and four copies of the Reply Comments of the Ad Hoc Telecommunications Users Committee in the above-captioned matter. Please date stamp the additional copy and return it with our messenger.

If you have any questions regarding this filing, please do not hesitate to call.

Sincerely,



Kevin S. DiLallo

Attorney for the
AD HOC TELECOMMUNICATIONS
USERS COMMITTEE

Enclosures

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JAN 10 1997

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of)

Federal-State Joint Board on)
Universal Service)

CC Docket No. 96-45

**REPLY COMMENTS OF THE AD HOC
TELECOMMUNICATIONS USERS COMMITTEE**

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January 10, 1997

SUMMARY

The Ad Hoc Telecommunications Users Committee endorses the recommendations of the Joint Board, with certain caveats. These caveats are aimed at furthering two pivotal goals of the Telecommunications Act of 1996 -- encouraging competition and eliminating implicit subsidies -- while focusing attention on the fundamental goal of the universal service support program: ensuring affordable access to basic telecommunications services for all Americans.

If these objectives are to be achieved in a cost-effective manner, the services to be supported by the Universal Service Fund should closely track the criteria Congress set forth in Section 254 of the 1996 Act. The provision of secondary lines does not even approach those criteria, and the Commission should reject suggestions that secondary lines be eligible for universal service support.

Based on the comments that have been filed in this docket, the Commission faces two important choices in determining how to allocate responsibility for contributing to universal service support mechanisms: Whether to use the “value-added” or “retail revenues” allocation method; and whether to base carriers’ contributions on interstate *and* intrastate telecommunications revenues or only on interstate revenues.

Although some commenters have proposed that the Commission adopt a gross revenues method of allocating contributions, such an approach would be

economically irrational in that it would result in double counting of certain revenues. For example, revenues from interstate switched access services sold to interexchange carriers (“IXCs”) would be included in both the IXCs’ revenue base (since they resell these services), and the local exchange carriers’ (“LECs”) revenue base.

Either the “value-added” approach or the “retail revenues” approach would be more economically rational than the gross revenues approach.

The value-added method allocates contribution obligations on the basis of each carrier’s gross telecommunications revenues net of payments to other carriers. The “retail revenues” approach allocates contributions based on a carrier’s revenues only from sales of telecommunications services to end users; revenues from services, such as interstate access, sold on a wholesale basis as inputs for other telecommunications services are excluded. Given certain assumptions, the two approaches would have generally equivalent effects on end users. Thus, more important than the allocation method chosen is the manner in which it is implemented.

To further the Congressional goal of competitive neutrality, the Commission should implement safeguards that prohibit carriers contributing to universal service from shifting resulting costs from more competitive to less competitive services. Such cost-shifting would disadvantage a carrier’s competitors and customers alike.

In addition, universal service contribution obligations should be allocated fairly so as not to disproportionately burden one or more classes of carriers or

users, relative to others. A system that disproportionately allocates contribution obligations would only perpetuate the economic efficiencies that mar today's subsidy-laden system.

Finally, universal service contributions should be allocated in a manner that is easy to administer and monitor. The value-added approach to allocating contribution responsibilities would satisfy this criterion, because the Commission already assesses common carriers on this basis and most carriers have accounting systems in place that can collect the information needed to apply the value-added method.

While the value-added and retail revenues approaches could be implemented in a manner that would have approximately the same effect on end users generally, they could have very different impacts on carriers, particularly so depending on whether the Commission includes intrastate and interstate revenues or only interstate revenues in the funding base.

An allocation method based only on interstate revenues would result in the incumbent LECs ("ILECs") contributing relatively less to universal service support, especially under the retail revenues approach (since the vast majority of ILECs' interstate revenues are derived from excluded wholesale switched access services). To promote competitive neutrality and discourage implicit subsidies, the Ad Hoc Committee encourages the Commission to adopt an approach that bases universal service contributions on both interstate and intrastate revenues.

Regardless of which allocation method is chosen, the Commission should require carriers to recover their contributions through end user surcharges. This

would satisfy the 1996 Act's requirement that the universal service support system be "explicit" and it would make the system accountable to those that ultimately pay for the system – consumers of telecommunications services.

The Joint Board's tentative proposal to reduce the subscriber line charge ("SLC") if carrier contributions are based on both inter- and intrastate revenues is at odds with the Board's own recommendations concerning the carrier common line charge ("CCLC"). Ad Hoc and others submit that a lower SLC would be economically inefficient and contrary to economic principles of cost causation, which argue for allocating the entire cost of the loop to the end user as a direct cost of basic local exchange service. Overwhelming economic justifications support eliminating the CCLC and increasing (or at least maintaining) the SLC. At a minimum, the SLC should not be reduced unless and until all non-economically efficient methods of recovering loop costs have been fully eliminated.

The Ad Hoc Committee believes that the Commission should ensure that support programs for schools and libraries are consistent with sound principles of public finance. The Commission should, for example, provide for a comprehensive review, every five years, of whatever support program is adopted to evaluate whether the program is achieving its goals, whether funding levels are appropriate, and whether changes in technology warrant re-focusing support targets.

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**REPLY COMMENTS OF THE
AD HOC TELECOMMUNICATIONS USERS COMMITTEE**

The Ad Hoc Telecommunications Users Committee ("Ad Hoc" or the "Ad Hoc Committee") submits these Reply Comments in response to the comments on the Federal-State Joint Board's Recommended Decision, released November 8, 1996.¹

INTRODUCTION

As detailed in its Comments in this docket, Ad Hoc believes that the Joint Board's Recommended Decision propels the universal service support system in the direction of competitive neutrality and away from the distorted pricing and hidden subsidies characterized by today's system. Ad Hoc has therefore urged the Commission to adopt the Joint Board's recommendations with certain clarifications and modifications that would better encourage the development of competition and fair distribution of universal service support.

¹ *In the Matter of Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Recommended Decision, FCC 96J-3 (released November 8, 1996) ("Recommended Decision").

I. UNIVERSAL SERVICE SUPPORT MECHANISMS SHOULD SUBSIDIZE ONLY ELIGIBLE PRIMARY LINES.

Certain commenters, including the United States Telephone Association (USTA), SBC Communications, Inc. (SBC), and Pacific Telesis Group (PacTel), have urged the Commission to include the provision of secondary telephone lines as a supportable service.² This proposal betrays the principles, set forth in the Telecommunications Act of 1996 (the "1996 Act"), that Congress has stated should guide universal service reform.³

USTA argues that the burdens associated with excluding secondary lines from the list of core supportable services "strongly outweigh any benefits."⁴ According to USTA, these burdens consist mostly of the alleged difficulty in differentiating between primary and secondary lines on billing statements, and thereby misidentifying primary lines as secondary lines. SBC raises the same concerns, pointing to "non-traditional living arrangements" where, for example, children returning home to live with their parents may "require" a second line.⁵ These commenters' concerns are based on conclusory assumptions and are manifestly self-serving. More importantly, they fail to demonstrate how the

² USTA Comments, filed December 19, 1996, at 30-31; SBC Comments, filed December 19, 1996, at 37-39; PacTel Comments, filed December 19, 1996, at 19-20.

³ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) (codified at 47 U.S.C. Section 151 *et. seq.*) ("1996 Act").

⁴ USTA Comments, at 30.

⁵ SBA Comments, at 38.

subsidization of secondary lines through the universal service program satisfies Congress's objectives and instruction in Section 254 of the 1996 Act.⁶

In defining the services that should receive universal service support, Congress has advised the Commission to consider whether a telecommunications service is "essential to education, public health, or public safety," "subscribed to by a substantial majority of residential customers," "deployed in public telecommunications networks," and "consistent with the public interest, convenience, and necessity."⁷ Thus, for example, even if a "substantial majority" of consumers subscribed to a service, the service would not be eligible for universal service support if it is not "essential to education, public health, or public safety." Secondary lines fall into this category.

First, the commenters provide no factual support to demonstrate that a majority of consumers subscribe to secondary lines.⁸ Second, they fail to show how secondary lines are essential to the education, public health or public safety of American consumers. Third, the commenters' claimed administrative difficulties in differentiating between primary and secondary lines are highly

⁶ PacTel's argument that universal service funding should apply to all residential lines because Section 254 does not distinguish between first and second residential lines or primary and secondary residences, is untenable. PacTel Comments, at 19. *Nothing* in Section 254 identifies particular services. In fact, there is no mention of "lines" at all, let alone residential lines. The Commission left the Joint Board to determine which services qualify as core universal services. PacTel's statutory argument is pure fiction.

⁷ 47 U.S.C. § 254(c)(1)(A).

⁸ According to data available from the FCC Industry Analysis Division, roughly 15% of households with telephones had additional lines as of the end of 1995. FCC Industry Analysis Division, *Percentage Additional Residential Lines for Households with Telephone Service*, 1996 (unpublished).

speculative. The fact that very few other parties found this issue worth pursuing in their initial comments casts doubt on SBC's assertion that the omission of secondary lines as a core service would be "unreasonable, and practically impossible to implement."⁹ Billing systems either are now capable of distinguishing between primary and secondary residential lines or can be changed to add this capability.

Contrary to SBC's position, it would not be a "drastic and unexplained departure from previous universal service policies" to omit secondary lines as a core universal service.¹⁰ Secondary lines have never been considered a core universal service. Thus, to support this service would be to depart from past and present universal service policies, which are aimed at supporting services which are essential to public health and safety or otherwise consistent with the public interest, convenience or necessity -- not those services which are, by comparison, a luxury.

⁹ See SBC Comments, at 37.

¹⁰ *Id.* In support of this statement, SBC argues that because "low-priced and readily available residential service has always been the primary universal service objective," and ILECs are already required to provide service to second homes at averaged prices "for the express purpose of achieving universal service goals," the Joint Board's exclusion of secondary lines as a supportable service is both inconsistent and unreasonable. SBC Comments, at 37-38. No where, however, does Congress state that "low-priced" and "readily available" residential service is a primary universal service objective in itself. Rather, it is a Section 254 principle that "[q]uality services should be available at just, reasonable and affordable rates." In this regard, the Joint Board found no evidence to support that owners of second or vacation homes cannot afford rates reflective of a carrier's costs of providing second connections. SBC provides no evidence demonstrating otherwise, and even acknowledges that the Joint Board's presumption "might have some validity." *Id.* at 38.

II. CONTRIBUTIONS TO THE UNIVERSAL SERVICE FUND SHOULD BE ALLOCATED IN A MANNER THAT IS COMPETITIVELY NEUTRAL, NONDISCRIMINATORY, EXPLICIT, AND EASY TO ADMINISTER AND MONITOR

In the Recommended Decision, the Joint Board proposed that the Commission adopt a value-added approach for allocating carrier contributions to the universal service fund, where "value-added" is defined as the carrier's gross common carrier service revenues net of payments to other carriers.¹¹ Under the value-added approach, each carrier is assessed based on the revenues that a carrier derives from adding value to other telecommunications services.¹² The total revenue base on which universal service contributions are allocated under this approach is derived by adding the amounts paid by all carriers at succeeding stages of production.

A number of commenters, however, including most incumbent local exchange carriers ("ILECs") as well as a few interexchange carriers ("IXCs"), strongly endorse an alternative allocation based on retail telecommunications revenues.¹³ Under the retail revenues approach, each carrier is assessed based on the gross revenues derived from the carrier's charges to end users, *i.e.*, at the final point of sale to end users, not from charges to other carriers. Many commenters further argue for the application of an explicit end user surcharge as

¹¹ Recommended Decision, at ¶ 807.

¹² The value-added approach, as applied to universal service funding, is also referred to as "NetTrans Account System." See Eli Noam, "Beyond Liberalization III, Reforming Universal Service," *Telecommunications Policy* 1994 18 (9), at 694-695.

¹³ See Ameritech Comments, filed December 19, 1996, at 35; Bell Atlantic Comments, filed December 19, 1996, at 10; BellSouth Comments, filed December 19, 1996, at 15; NYNEX Comments, filed December 19, 1996, at 23; SBC Comments, at 11; USTA Comments, at 22; AT&T Comments, filed December 19, 1996, at 8; Sprint Comments, filed December 19, 1996, at 9-10.

the means of recovering universal service contributions under the retail revenues approach.¹⁴

While there are a number of important distinctions between the value added and retail revenues allocation approaches, under certain circumstances, these two methods could produce essentially equivalent outcomes for end users. Accordingly, the Ad Hoc Committee does not strongly favor one method over the other at this time.¹⁵ Rather, Ad Hoc urges the Commission to adopt safeguards to ensure that whichever method is adopted will be implemented in a manner that promotes economic efficiency and competitive entry consistent with the 1996 Act and the public interest.

A few key principles should further those goals. First, the approach adopted must be implemented in a manner that is competitively neutral, *i.e.*, does not place one class of competitors at a competitive advantage or disadvantage vis-à-vis others. For example, the system should not afford dominant carriers who provide both non-competitive and competitive services the opportunity to shift strategically the recovery of their universal service contributions to less competitive service offerings, thereby subsidizing more competitive offerings. Such cost-shifting would disadvantage a carrier's customers and competitors alike.

Second, all carriers and end users should bear their fair share of the universal service burden, defined as a function of either their output (if carriers) or consumption (if users) of all telecommunications services. The Commission

¹⁴ See AT&T Comments, at 8-9; Sprint Comments, at 10; Bell Atlantic Comments, at 8; BellSouth Comments, at 15-16; PacTel Comments at 21; US West Comments, filed December 19, 1996, at 45; NYNEX Comments, at 23-25; SBC Comments, at 11-14; USTA Comments, at 22-23.

¹⁵ The Ad Hoc Committee has previously endorsed the value added allocation approach, but, for the reasons discussed *infra*, now believes that the two approaches could ultimately produce similar results *if* the proposed safeguards are adopted.

should not replace the current subsidy-laden support system with one that disproportionately burdens different classes of carriers or users.

Third, the approach adopted must be easy to administer and monitor; to the extent possible, allocations should be based on data that is already reported or at least easily verified, rather than on data that may be difficult to collect or verify. And fourth, the approach adopted should make the universal service program accountable to the public, and thereby promote overall subsidy levels that are maintained at responsible levels tailored to meet the goals of the 1996 Act.

As discussed below, either a value-added or retail revenues approach, appropriately administered, could further these principles. Moreover, given certain assumptions, these two methods are likely to converge. Thus, the more important issue is not which method is chosen (that is, as between the value-added and retail revenues approach), but how it is implemented.

A. If Appropriately Implemented, The Value-Added Or Retail Revenues Approaches Are Likely To Converge, And Either Could Satisfy The Key Principles Outlined Above

As the Joint Board recognized, the value-added approach offers several distinct advantages over other proposed methods of assessment.¹⁶ In particular, as the Ad Hoc Committee has previously noted, assessing common carriers based on the value they add results in each telecommunications dollar being “taxed” only once.¹⁷ By contrast, an assessment based on gross telecommunications revenues would fail to achieve the overarching objective of competitive neutrality because it

¹⁶ Recommended Decision at ¶ 807.

¹⁷ Ad Hoc Initial Comments in CC Dkt. No. 96-45, filed April 12, 1996, at 21 (“Ad Hoc Initial Comments”).

would result in certain providers (e.g., IXCs) calculating their contributions on the basis of both their retained revenues *and* the amounts they pay to other telecommunications carriers, while other carriers (those that do not resell services purchased from other carriers) would calculate their contributions based only on their retained revenues.¹⁸

In addition, as the Joint Board noted, the value-added method is easy to administer.¹⁹ Moreover, some economists consider the value-added method to be less complex, more competitively neutral, and based on sounder underlying principles than other allocation methods.²⁰

Like the value-added approach, the retail revenues method eliminates the critical double taxation problem and therefore is more economically rational than an assessment based solely on carriers' gross revenues.²¹ The Joint Board rejected the retail revenues approach, however, because that approach would unfairly relieve wholesale carriers from directly contributing to support mechanisms, thereby failing to achieve competitive neutrality.²² It should be noted that the retail revenues approach would also relieve carriers that provide a combination of wholesale services (such as interstate switched access provided to carriers) and retail services (such as dedicated access provided to end users) of the responsibility of contributing based on revenues they receive for wholesale

¹⁸ Recommended Decision, at ¶ 810.

¹⁹ *Id.* at ¶ 807.

²⁰ See, e.g., Eli Noam, "Beyond Liberalization III, Reforming Universal Service," *Telecommunications Policy* 1994 18 (9), at 701-702.

²¹ Recommended Decision, at ¶¶ 808, 811.

²² *Id.*

services. In the case of the ILECs, this would mean that some \$23.4 billion dollars of revenues would be excluded from their contribution base.²³

In addition to competitive neutrality concerns, the Joint Board also noted the difficulties of tracking and verifying retail revenues, a problem not encountered with the value-added approach, since the Commission already collects common carrier regulatory fees on this basis and most common carriers already have accounting systems in place to calculate gross revenues and payments to other carriers.²⁴ And advocates of the value-added approach have raised still other administrative and implementational concerns with respect to the retail revenues approach.²⁵

Supporters of the retail revenues approach respond that their recommended approach offers a simpler, fairer, allocation system that is easier to administer and audit than the value-added approach would produce.²⁶ AT&T argues in particular that the imposition of a mandatory retail surcharge on end users' bills would best ensure competitive neutrality by requiring carriers to assess the cost of universal service proportionately across all of their services, rather than strategically shifting that cost to non-competitive services. In addition, AT&T

²³ See *Access Charge Reform*, CC Docket No. 96-262, Notice of Proposed Rulemaking (released December 24, 1996), at Table 1.

²⁴ Compare Recommended Decision, at ¶¶ 807 with Recommended Decision at ¶ 811.

²⁵ In his article advocating implementation of a value-added approach (or "Net Trans" account system) to funding the universal service system, Eli Noam raises specific concerns regarding implementation of a retail sales approach, including the questions of how the Commission would determine who is an end user and what kinds of billings would be exempted from assessment. See Eli Noam, "Beyond Liberalization III, Reforming Universal Service," *op cit*.

²⁶ See, e.g., USTA Comments, at 15-16; AT&T Comments, at 9; Sprint Comments, at 9; and Bell Atlantic Comments, at 11.

argues that the end user surcharge offers the “added benefit of enabling regulators to prevent the subsidy from spinning out of control in the future.”²⁷

Supporters of the retail revenues method argue that, whether wholesale or retail revenues provide the basis for assessment, the ultimate effect on end users will be the same.²⁸ As explained by Sprint:

If revenues net of payments to other carriers is the contribution base, LECs will simply pass through a portion of their universal service contribution to IXCs in the form of higher access charges, and IXCs will accordingly adjust their long distance service rates to recover this LEC pass through. (LECs and IXCs will also pass through to their end user customers the universal service contributions based on the value-added portion of their revenues as well.) Basing carrier contributions on interstate and intrastate retail revenues eliminates the interim step (pass through on access charges) and will allow each carrier to recover its universal service obligation via an explicit charge on each end user's bill.²⁹

The claim that the retail revenues and value-added methods of assessment should have equivalent effects on end users is supported in the economic literature on public finance and taxation.³⁰ As explained in the context of taxation,³¹

²⁷ AT&T Comments at 8-9, *citing* Notice of Proposed Rulemaking and Order Establishing Joint Board, FCC 96-93, released March 8, 1996 (“NPRM”), at ¶ 28.

²⁸ Bell Atlantic Comments, at 11; Sprint Comments, at 9-10.

²⁹ Sprint Comments, at 10.

³⁰ See, e.g., Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, McGraw Hill, 1976 (“Musgrave & Musgrave”), at 330-331, 337-341; see also Harvey S. Rosen, *Public Finance*, 3rd. Ed., Irwin, 1992, Chapter 20, at 496.

³¹ While the universal service contribution to be implemented by the Commission is clearly not a tax *per se*, the value-added and retail revenues allocation mechanisms under consideration by the Commission are analogous in several respects to a tax. Characterization of universal service contributions or charges to recover such contributions as a “tax” are, however, imprecise and incorrect as a definitional matter, could potentially create consumer confusion, and spur unwarranted claims that the Commission has attempted to usurp Congress’ taxing authority. Absent unlawful, anticompetitive manipulation and cost-shifting by the collecting carriers, universal service

as a general proposition, a value-added tax will have the same base as a retail sales tax on the same goods and services. The primary difference is whether the tax is collected only at the final point of sale (as under the retail method) or whether it is applied and collected at multiple succeeding stages of production based on the value added to the product at each stage. From the economist's viewpoint, the two methods are equivalent:

At each stage, the value of the product is increased and the sales price rises accordingly. Each increment in price reflects the value-added at that stage, with the value or price of the final product equal to the sum of the increments or values added at the various stages. A tax imposed on the increments is thus identical in its base to a tax imposed on the final value of the product.³²

A simplified numerical example illustrates this point from the perspective of an IXC providing only interstate services, and the IXC's customers:

Retail Revenues: Assume that an IXC has total telecommunications retail revenues of \$10 million, \$4 million of which it pays in switched access charges to the ILEC, and \$6 million of which are value-added revenues. Assume further that the universal service "burden rate" -- the ratio of the universal service funding requirement to the aggregate revenue base of telecommunications revenues -- is 1%. Under the retail revenues method, the IXC would be assessed 1% of its total telecommunications retail revenues, or \$100,000, which it presumably would recover by charging its customers higher rates. The IXC would need to recover \$10,100,000 in revenues from end users to recover its universal

contributions and charges to recover such contributions are nothing more than regulatory fees imposed at the direction of Congress to implement federal policies.

³² Musgrave & Musgrave, at 337.

service contribution and maintain its profitability level, all other things being equal. The ILEC would pay nothing on its interstate switched access revenues.

Value Added: Under the value-added approach, the IXC would be assessed (1% in this example) only on the value-added portion of its revenue base (\$6 million), for an assessment of \$60,000. The ILEC would be assessed 1% on its revenues from switched access services sold to the IXC (1% of \$4 million or \$40,000). The ILEC presumably would pass on its \$40,000 universal service contribution in the form of higher switched access charges, resulting in switched access charges to the IXC of \$4,040,000. At that rate, the IXC would again need to recover a total of \$10,100,000 -- \$4,040,000 to be paid in switched access charges, \$6 million value-added revenues, and \$60,000 to recover its own direct universal service contribution.

Aggregate Impact: While the IXC's universal service contribution *per se* would be lower under the value-added approach, the costs the IXC would ultimately need to recover from its end users and therefore the economic incidence or burden of the universal service contribution, would be the same under either scenario -- again, assuming that the ILEC passes through its universal service contributions dollar-for-dollar to the IXC. The only difference between the two scenarios would be the relative amounts paid into the fund by the IXC and the ILEC, *i.e.*, the nominal payor of the universal service contribution.

More generally, the significant difference between the methods lies primarily in the share of the universal service contribution allocated among various carriers. Under the value-added method, more of the contribution is collected at wholesale stages of production, such that the wholesale carriers (primarily ILECs) will be assigned a greater share of the collection duty than they would under the retail

revenues method. This difference is magnified, however, with the choice of revenue base. Because the ILECs have proportionately more intrastate revenues, and moreover, their *interstate* revenues are largely wholesale (access) services, rather than retail services, the relative contributions that the ILECs would make under the two approaches would differ substantially depending on whether the revenue base was interstate only or combined interstate and intrastate.

Under the retail revenues approach, if only interstate revenues are included in the base, the ILECs would have to make very little, if any, contribution to universal service funding. On the other hand, if combined intrastate and interstate revenues are included -- as the Ad Hoc Committee advocates (see below) -- the ILECs' share of the total universal service burden under the retail revenues approach would be significant, reflecting their substantial base of intrastate revenues. In the aggregate, ILECs enjoy intrastate revenues of in the range of \$73 billion, the lion's share of which are retail revenues.³³ Under the value added approach, the choice of revenue base also has a significant effect on the ILECs' relative contribution to the fund, although to a lesser degree than under the retail revenues approach.³⁴

³³ Telecommunications Industry Revenue TRS Fund Worksheet Data, Industry Analysis Division, Common Carrier Bureau (February 1996) (data as of the end of 1994).

³⁴ Rough analysis using 1994 data available in the Telecommunications Industry Revenue TRS Fund Worksheet Data, Industry Analysis Division, Common Carrier Bureau (February 1996), suggests, under the value-added approach, that use of an interstate only revenue base would result in ILECs, in the aggregate, being allocated around 41% of the required contribution, with roughly 54% being allocated to IXC's and the remaining 5% being allocated among miscellaneous carriers (CAPs, cellular carriers, and resellers). By contrast, use of a combined intrastate and interstate revenue base would result in ILECs being allocated approximately 64% of the contribution, with the contribution allocated to IXC's dropping to 25%, and the contribution allocated to other carriers (in particular cellular carriers) increasing to approximately 10%.

Assuming that ILECs are allowed to pass on their universal service costs to wholesale customers, however,³⁵ they will not (contrary to USTA's argument³⁶) bear any greater share of the burden of the universal service funding obligation, relative to other telecommunications service providers under the value added approach. And although new entrants in local exchange/exchange access and interexchange markets would be allocated a smaller share of the collection duty under the value added approach than under the retail revenues method, they would bear a larger share of the universal service funding obligation in the form of higher prices paid to ILECs for wholesale services.³⁷ In theory, end user customers should bear the same approximate share of the universal service obligation, regardless of the allocation system adopted.

Thus, the aggregate impact on end users *generally* is the same under either approach. If, however, only interstate revenues are included in the revenue base, the IXC's relative universal service contribution burdens would be disproportionately higher (particularly so under the retail revenues method) and revenues from interexchange services will subsidize local service, a result that Congress has instructed the Commission to avoid.³⁸ Therefore, as discussed

³⁵ In this regard, although the Joint Board has not made an explicit recommendation as to whether carriers should be permitted to pass through all of their universal service contributions, it has specifically noted that "carriers are permitted under section 254 to pass through to users of unbundled elements an equitable and nondiscriminatory portion of their universal service obligation." Recommended Decision, at ¶ 808.

³⁶ USTA Comments, at 16.

³⁷ This assumes that only interstate revenues are included in the revenue funding base and that the ILECs pass through their universal service contribution costs to their wholesale customers.

³⁸ See 47 U.S.C. § 254(b)(4), (5), § 254(k).

further, it is critical that both inter- and intrastate revenues be included in the revenue base on which universal service contributions are calculated.

As noted above, however, the foregoing analysis and simplified example make some critical assumptions. First, they assume that carriers will pass on their universal service contributions dollar-for-dollar to all their customers, wholesale and retail alike. Second, they assume that carriers will distribute these costs proportionately among their service offerings.

Commenters arguing that both methods are equivalent seem to take these points for granted.³⁹ Other commenters acknowledge the lack of explicit recommendations by the Joint Board in these areas and thus make specific recommendations. Bell Atlantic, for example, has urged the Commission, should it adopt the value-added approach, to permit carriers to pass on universal service contributions through to all their customers, wholesale as well as retail.⁴⁰ It is a well understood characteristic of a competitive market environment that firms will ultimately have to pass on their costs of production to consumers in order to stay in business.⁴¹ But given the complexity and number of overlapping inter-relationships among carriers that are occurring and will likely continue as a result

³⁹ See Sprint Comments, at 9-10.

⁴⁰ Bell Atlantic Comments, at 8-10.

⁴¹ As Bell Atlantic points out, "[i]t is not the telecommunications carriers, but the users of telecommunications services to whom these costs will be passed through in a competitive marketplace." *Id.* at 8 (citing Separate Statement of FCC Commissioner Rachelle B. Chong, Concurring in Part, Dissenting in Part, CC Dkt. No. 96-45 (released Nov. 7, 1996) ("Statement of Commissioner Chong"), at 14).

of the 1996 Act, tracking and predicting the pass-through of universal service contributions will not necessarily be straightforward or predictable.⁴²

If the Commission adopts the value-added approach, AT&T recommends that the Commission "require each carrier's obligation to be recovered equiproportionally from all services."⁴³ Ad Hoc agrees that, because dominant carriers will offer a mix of non-competitive and competitive service offerings for the foreseeable future, they will have both the opportunity and the incentive to burden non-competitive service offerings with a disproportionate share of their allocated universal service obligations.⁴⁴ Such a scenario is at odds with the principle of competitive neutrality, and poses potential harm to both customers and competitors of the ILECs.

Ad Hoc also submits that explicit end user awareness of the universal service obligation is key to ensuring competitive neutrality (through public accountability) and creating pressure to keep overall subsidy levels reasonable.⁴⁵ Achieving this objective, however, does not require use of the retail revenues approach, as its advocates suggest. With appropriate billing practices, the end

⁴² As recognized by the Commission in its Interconnection decision, the three major regulatory initiatives spawned by the 1996 Telecommunications Act -- universal service funding, interconnection and unbundled network elements, and access charge reform -- are closely intertwined. *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order (CC Docket No. 96-98), 61 Fed. Reg. 45476, Published on August 29, 1996 ("Interconnection Order"), at ¶¶ 6-10.

⁴³ AT&T Comments, at 9, note 5. AT&T also recommends that this obligation be reflected as a line-item on the services bill.

⁴⁴ For example, without prohibiting such cost-shifting, the ILEC would be expected to target terminating switched access, the least elastic element of switched access service and among the least likely to experience effective competition, to bear a disproportionate share of the universal service contribution.

⁴⁵ See, e.g., AT&T Comments, at 8-9; USTA Comments, at 22; Bell Atlantic Comments at 8-10; Ameritech Comments, filed December 19, 1996, pp. 34-35; SBC Comments, at 11-14; NYNEX Comments, at 23-25; BellSouth Comments, at 15-16.

user could be made aware of his or her own share of the universal service cost burden under either approach.⁴⁶

AT&T notes that although the Joint Board specifically “recommended against requiring universal service support to be reflected on the end user bill as a surcharge,” the Joint Board did not “prohibit[] carriers from separately stating the costs of universal service support on customer bills.”⁴⁷ The end user public -- who ultimately will pick up the tab for universal service -- should be fully informed of the magnitude of the program, and public awareness can be achieved under either the value-added or retail revenues approach.

The Ad Hoc Committee would disagree with any suggestion that the retail revenues approach is the only approach that lends itself to the imposition of an end user surcharge, as AT&T seems to suggest. The allocation of contribution responsibility and the manner in which contributions are recovered from end users are two distinct and unrelated matters. Thus, even if carriers’ contributions are based on a value-added approach, carriers can still recover their contributions through an end user surcharge or more generally in a manner that informs end users as to what they are paying toward universal service support.

⁴⁶ For example, in the context of a value-added tax, as commonly used throughout Europe, the retailer's gross tax could be shown as a separate part of the consumer's price. See Musgrave & Musgrave, *op cit*, at 341. Specifically applying the value-added concept to the allocation of universal service contributions in the telecommunications industry, Professor Eli Noam has noted that “any desired form of transparency of the burden can be given to the customer for any variety of systems, including NetTrans [value-added]. It is simply a matter of bill design.” Eli Noam, “Beyond Liberalization III, Reforming Universal Service,” *op cit.*, at 701-702.

⁴⁷ AT&T Comments, at 8, note 4 (citing Recommended Decision, at ¶ 812).

B. A Carrier's Contributions To The Universal Service Fund Should Be Based on Its Combined Interstate And Intrastate Telecommunications Revenues.

Commenters are divided on the issue of whether carrier's universal service contributions should be based on interstate revenues only or combined interstate and intrastate revenues. NYNEX, SBC, and Bell Atlantic have argued that under Section 254 of the 1996 Act, the Commission should limit the federal funding mechanism to *interstate* retail revenues, and allow the states to develop their own contribution mechanisms based on *intrastate* revenues.⁴⁸ USTA, BellSouth, US West, and GTE Service Corporation ("GTE"), however, all favor an assessment based on combined interstate and intrastate retail revenues.⁴⁹ These parties cite increasing difficulties in determining the jurisdictional nature of certain services, as well as the need for a broader funding base.⁵⁰

A funding base combining interstate and intrastate revenues best satisfies the principles of competitive neutrality that are embodied in the Act and are necessary for meaningful competition to develop in the local exchange and exchange access markets. Combining interstate and intrastate revenues is even more important as a policy matter if the retail revenues approach is adopted, since, as discussed above, that approach excludes wholesale services, such as interstate access, from the funding base, and the vast majority of the ILECs' interstate revenues are derived from such services.⁵¹ Thus, a retail revenues approach based only on interstate revenues would ignore more than 25% of the

⁴⁸ See NYNEX Comments, at 18; SBC Comments, at 14-15; Bell Atlantic Comments, at 10-11.

⁴⁹ USTA Comments, at 17; BellSouth, at 10; US West, at 16; GTE, at 66.

⁵⁰ BellSouth, at 10; GTE, at 67-70; US West, at 19.

⁵¹ See Recommended Decision at ¶ 805, *citing* NCTA Reply Comments at 25.